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SUBJECT: ARGENTINA ECONOMIC AND FINANCIAL REVIEW, MAY 26 -
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¶1. (U) Provided below is Embassy Buenos Aires' Economic and Financial Review covering the period May 26 - June 4, 2008. The unclassified email version of this report includes tables and charts tracking Argentine economic developments. Contact Econoff Chris Landberg at landbergca@state.gov to be included on the email distribution list. This document is sensitive but unclassified. It should not be disseminated outside of USG channels or in any public forum without the written concurrence of the originator. It should not be posted on the internet.

Highlights

-- GoA announces mostly cosmetic changes to export tax regime; conflict continues
-- Strong April primary fiscal surplus, despite accelerating growth rate of expenditures
-- Interest rates skyrocket to 16-17%, while private sector deposits fall by ARP 6 billion
-- GoA sells \$1.0 billion of Boden 2015 to Venezuela at a record yield of 12.90%
-- Trade booming in 2008, although spike in exports due mostly to higher prices

Agriculture

GoA announces mostly cosmetic changes to export tax regime; conflict continues

¶2. (SBU) On May 26, seventy-nine days after the initial outbreak of the conflict between the GoA and Argentine farmers, the GoA announced a unilateral amendment to the "retenciones moviles" (sliding scale export taxes) that had prompted the conflict in the first place (See April 4 Econ/Fin report and extensive Post reporting for background). With the amendment, the GoA lowered the export tax rate on soybean exports when international prices rise above \$600 a ton (\$16.33 per bushel), a level far above current prices of \$485 a ton. (Note: The GoA amendment reduced the soy export tax from 55.9% to 51.7% for prices between \$700 and \$750 a ton and from 58.5% to 52.7% for prices above \$750 a ton, while retaining the existing tax rates for prices below \$700/ton.)

¶3. (SBU) In tandem, the GoA resolution lowered the tax rates on corn, wheat, and sunflower exports for price levels above \$350, \$500, and \$800, respectively. With this amendment, the GoA argued it had corrected problems for the futures market caused by the high marginal rate at high prices of an

estimated 95% and that this should be enough for producers who are still making a profit at current export tax levels. However, this change falls far short of resolving the conflict, as farmers characterized the amendments as purely cosmetic. Farm groups stated that, at current world prices, Argentine exporters of these agricultural commodities will continue to pay the same tax rate as before, and prices would have to increase to record levels in order to see any reduction from the previous requirements.

14. (SBU) On May 28, the day before the GoA announced the policy change, the main farming groups restarted protests, including partial road-blocks and withholding grain, oilseed, and cattle sales, after the GoA canceled planned discussions with the sector. On June 2, the same organizations agreed to extend the bans on sales and exports of grains and oilseeds until June 9, while restoring the sale of cattle for slaughter to avert disruption to domestic supply. The withholding of grain and oilseed sales is already affecting Argentine exports, since exporters (including soybean crushers) have been working with stocks held at port, which are being rapidly depleted.

Fiscal

Strong April primary fiscal surplus, despite accelerating growth rate of expenditures

15. (SBU) Strong revenue growth so far in 2008 indicate the primary fiscal surplus will be stronger than during the 2007

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election year, when expenditures spiked to almost 50%. However, increasing subsidies are a worrisome trend.

16. (SBU) The GoA announced May 19 a primary fiscal surplus of ARP 2.8 billion (\$889 billion) for April, a 73% y-o-y increase. This strong April result is explained by rising revenues (up 55% y-o-y), overwhelming also-rapidly-accelerating primary expenditures, which increased 52% y-o-y compared to the March increase of 29% y-o-y. After growing at a rate of 47% y-o-y in 2007, primary expenditures decelerated sharply in the first quarter of 2008 to 35% y-o-y. This led most analysts to believe that President Cristina Fernandez de Kirchner would hold to her promise of targeting a strong primary fiscal surplus. (Note: The GoA announced June 4 that May tax collection hit a historic record of ARP 24.3 billion (up 28.5% y-o-y))

17. (SBU) The decelerating trend reversed in April, raising the y-o-y increase for the first four months of 2008 to 39%. Local private analysts speculate that the GoA delayed payments during the first quarter, in order to demonstrate a lower growth rate for expenditures, and the April spike included March expenditures paid in April. (Note: GoA fiscal accounts are calculated on a cash basis, meaning income and expenditures are accounted for when they are paid, instead of on an accrual basis, where income and expenditures are accounted for when they are realized (and independently of when they are paid)).

18. (SBU) April's strong primary surplus also included an ARP 450 million transfer from the BCRA to the GoA. (Note: the BCRA is obligated to either apply earnings to increase its capital or transfer them to the GoA. The BCRA had already transferred earnings of ARP 1 billion in March, so with the April transfer the BCRA has already completed the total amount of transfers -- ARP 1.4 billion -- included in the 2008 budget (which corresponds to BCRA earnings in 2007). On June 2, Argentine daily Cronista Comercial reported that the BCRA may decide to send additional earnings of about ARP 1 billion during 2008. (Note: the decision is up to the BCRA's Board of Directors.) Private sector analysts estimate that the BCRA's earnings in 2007 exceeded ARP 2.6 billion,

which would allow the ARP 1.0 billion additional funds transfer to the GoA, while still allowing for a small portion to re-capitalize the BCRA.

¶9. (SBU) In the first four months of the year, accumulated primary expenditures reached ARP 53 billion (up 39% y-o-y), while accumulated revenues stood at ARP 65 billion (up 44% y-o-y). This resulted in an accumulated primary surplus of ARP 11.6 billion. According to Argentine consulting company Economia y Regiones, if growth dynamics of revenues and expenditures continue as they have through April, the GoA's 2008 primary fiscal surplus should reach about 4% of GDP. This would be significantly above the official 2007 primary fiscal surplus of 3.2% of GDP (equivalent to ARP 25.7 billion or \$8.1 billion). (Note: The 2007 primary surplus was only 2.5% of GDP when excluding one-time transfers that resulted from the 2007 pension system reform.)

¶10. (SBU) Within expenditures, the evolution of subsidies deserves special focus. Subsidies reached ARP 16 billion in 2007 (explaining one-third of the 47% increase in 2007 expenditures), and analysts estimate that GoA subsidies could increase by a further 50% in 2008, to roughly ARP 20-23 billion (or 2 - 2.5% of GDP). Subsidies so far in 2008 are rising at an annual rate of about 103% (y-o-y in the first quarter), and there is no reason to believe that the GoA will reduce them soon, since the GoA strategy has been to use subsidies to avoid the need to increase domestic prices. And the GoA has not yet indicated its intention to raise tariffs for energy and transportation, the sectors that together account for 85% of subsidies. Additionally, new subsidies, such as those to the agricultural sector, are increasingly a concern. (Agro subsidies increased almost 50% in Q1.) Prominent local think tank Bein and Asociados estimates that, excluding the increase in subsidies to the private sector, the increase in primary expenditures would have been only 33% during the first four months of 2008 (compared to the effective increase of 39%) if it excluded the increase in subsidies to the private sector.

Finance

Interest rates skyrocket to 17%, while private sector

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deposits fall by ARP 6 billion

¶11. (SBU) Political uncertainty, accelerating inflation, and the Ag conflict created a move towards the dollar in May at the expense of private peso deposits. However, the BCRA appears to have succeeded in restoring market stability.

¶12. (SBU) Private sector deposits dropped ARP 6 billion (almost \$2 billion) during the period May 1 - 23 (latest available data from BCRA). The BCRA intervened strongly, selling dollars to stabilize (or even appreciate) the peso (the retail peso closed at 3.10 ARP/USD on June 2, having appreciated by 3.7%, from highs of 3.22 on May 9). Some local analysts concluded that the BCRA continued selling dollars and strengthening the peso several days longer than necessary to "punish" investors betting on a peso devaluation. The BCRA ultimately succeeded in demonstrating its ability to keep the exchange rate stable. It accomplished this by selling a total of 1.3 billion from April 23 to May 23, dropping reserves to \$49 billion. Some analysts estimate that BCRA dollar sales during this period were actually in the range of \$2 billion, but allege that the BCRA engaged in repo transactions with the BIS to disguise the lower reserve levels.)

¶13. (SBU) However, the BCRA took these actions at the cost of absorbing peso liquidity (with its dollar sales). Coupled with investor's withdrawals of funds, the BCRA's dollar sales pushed up interest rates, with the Badlar rate reaching 17%

on May 27, the highest level since February 2003 (Badlar is the reference rate for one-month time deposits over ARP 1 million). This compares to 14.3% on May 16 and to 8.6% on March 11, when the GoA imposed the export taxes sliding scale.

¶14. (SBU) The BCRA responded to this sharp increase in rates by announcing two measures on May 29 to increase liquidity in the financial system. First, the BCRA announced it will engage in dollar repo transactions (repurchase agreements) with banks. (Note: Allowing banks to satisfy their dollar demands by borrowing -- through the repos -- from the BCRA, instead of buying dollars on the FX market eliminates the monetary impact, as there is no reduction in peso liquidity.) Second, the BCRA altered bank supervision regulations to allow banks to meet deposit liquidity requirements for June and July on a bimonthly basis, as opposed to a monthly basis. (Note: The BCRA is doing this in the hopes that liquidity pressures will ease when the Ag conflict is solved. Otherwise, some banks would be forced to borrow to comply with liquidity requirements, thus exerting more upward pressure on interest rates.) These measures should help prevent interest rates from rising further.

¶15. (SBU) Many analysts expect deposits to start returning to the banking system, attracted by higher rates and the expectation that the nominal exchange rate will remain stable. Post Comment: All local analysts known to Emboffs agree that the BCRA has performed extremely well in handling the crisis of confidence that began in March, and clearly learned from its own mistakes made during the financial turbulence of July-August 2007, when local interest rates spiked (with the Call, or overnight, rate hitting a high of 22.8% on July 27, 2007, compared to a high of just 12.3% on May 15, 2008, falling to 9.3% by May 23.).

GoA sells \$1.0 billion of Boden 2015 to Venezuela at a record yield of 12.90%

¶16. (SBU) The GoA announced in the May 27 Official Gazette that it sold \$1.3 billion (face value), equivalent to about \$1.0 billion cash (effective value), in dollar-denominated Boden 2015 bonds to Venezuela. (The Boden 2015 is an Argentine law, 10-year, dollar denominated bullet bond. It was first issued October 3 2005, matures in 2015, and carries a fixed 7% coupon rate.) According to the GoA resolution, the bonds were issued through a private placement and were priced at market prices. The Bodens were reportedly priced at \$73, resulting in a yield of 12.90%, 247 basis points higher than the last issuance of the same bond to the GoV in November 2007, and 202 basis points higher than the December 2007 issuance of the same bond to the Argentine social security agency (ANSES). This is the first bond sale to the GoV this year, and was reportedly arranged by new Minister of Economy Carlos Fernandez during his trip to Venezuela on May 17. However, given the GoA's inability to issue debt internationally and current unwillingness to test the local market, local analysts do not discount the possibility of

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additional GoA sales to the GoV to meet the GoA's 2008 financing needs.

¶17. (SBU) From May 2005 to the present, the GoV has financed the GoA for a total of \$8.1 billion (face value), equivalent to \$6.6 billion cash (effective value) in over 20 separate transactions. Most analysts agree that GoA financial needs for the year are manageable. The GoA still needs to raise about \$5.0 billion (based on the GoA financial program), but domestic institutional investors -- pension funds, insurance companies, and banks -- and public sector agencies -- ANSES and AFIP (Argentine IRS) -- count with ample liquidity. In its 2008 Financial Program (see May 2 Econ/Fin Report), the Economy Ministry clearly states its intention to raise significant funds from these sources, and also indicates the intention to raise as much as \$1.5 billion during 2008 via

private placements, which Economy Ministry sources affirm is an oblique reference to bond sales to Venezuela.

¶18. (SBU) According to a May 6 JPMorgan report, 2008 GoA financial needs of \$6 billion are overestimated "due to the authorities' conservative assumptions...which unnecessarily include issuance to government agencies" within the gross debt issuance figures. JPMorgan estimates that actual market needs are roughly half the total, or only \$3 billion. JPMorgan goes one step further and concludes that demand from local pension funds will probably cover at least this \$3 billion amount, essentially reducing the financing gap in 2008 to zero.

Trade

Trade booming in 2008, although the spike in exports due mostly to higher prices

¶19. (SBU) April 2008 exports in dollar terms were up 35% y-o-y, while imports leapt 61% y-o-y. Industrial exports rose 41% y-o-y in April, followed by primary goods and agribusiness, which were both up 33% y-o-y. Exports and imports in the Jan-Apr. 2008 period totaled \$21.6 billion and \$17.8 billion, or 40% and 45% y-o-y increases, respectively. Argentina's trade surplus for the first four months of 2008 was \$3.8 billion, compared to \$3.2 billion for the same period in 2007. On a 12-month rolling basis, the trade balance was \$11.7 billion in April, slightly down from the \$12 billion in March, and almost equivalent to the \$11.6 billion trade surplus in April 2007.

¶20. (SBU) The 40% y-o-y export growth for Jan-April was due primarily to a 32% increase in prices, and a 5% increase in volumes. Primary export volumes were up by 7% (while prices grew 50%), and industrial export volumes were up by 19% (while prices grew only 8%). However, agribusiness export volumes fell by 2% (while prices grew 47%) and fuel and electricity export volumes fell by 23% (while prices grew 64%). The reverse situation was true for imports. Year-on-year import growth of 45% for Jan-April was led by volumes, which grew at an average annual 31%, while prices went up only 11%.

¶21. (SBU) Harvard-trained economist Juan Carlos De Pablo, owner of Contexto Consulting and professor at San Andres and CEMA universities, pointed out during an American Chamber of Commerce seminar on May 29 that a simulation exercise of Argentine trade with present volumes and 2007 prices would result in a trade deficit. One week before the April trade figures were officially released, Central Bank's President Martin Redrado wrote for Argentine daily La Nacion "the trade surplus, close to \$12 billion in 2008, guarantees a structural (italics are ours) supply of foreign currencies that will more than compensate whatever the current, circumstantial demand for dollars is, making any speculation about a nominal devaluation inappropriate." De Pablo's exercise throws doubt on the accuracy of Redrado's usage of the word "structural."

¶22. (SBU) Recent INDEC (national statistics agency) figures on U.S.-Argentina bilat trade in goods show 39% y-o-y growth for QI 2008. Argentine exports to the U.S. were \$1.4 billion, or 27.5% higher than in QI 2007. Argentine imports from the U.S. were \$1.7 billion, or 50.2% higher than in QI ¶2007. Total bilateral trade in goods in 2007 was \$9.7 billion, including Argentine exports of \$4.3 billion (mostly commodities) and Argentine imports of \$5.3 billion (mostly intermediate capital goods). Total bilateral trade in

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services in 2007 was \$4.0 billion, including Argentine exports of \$1.1 billion (up 6.8% y-o-y) and Argentine imports of \$2.9 billion (up 27.8% y-o-y).

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